



Investment Office

P.O. Box 2749

Sacramento, CA 95812-2749

Telecommunications Device for the Deaf - (916) 795-3240

(916) 795-3400

November 13, 2007

AGENDA ITEM 4b

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Inflation-Linked Asset Class – Organizational Structure
- II. PROGRAM:** Asset Allocation / Risk Management
- III. RECOMMENDATION:** Information
- IV. ANALYSIS:**

Background

In March 2007, the Investment Committee approved a Commodities Pilot Program. In September 2007, the Committee approved an Inflation-Linked Asset Class (ILAC) Pilot Program comprising Commodities, Inflation-Linked Bonds, Infrastructure and Forestland, as well as the reclassification of existing investments into the ILAC component accounts as of September 30, 2007. In addition, the Committee stipulated that new investments in these programs will be subject to Committee approval of a governing policy, and development of organizational structure and alignments of compensation incentives. This memo addresses the organizational structure. Incentive alignments will be more fully addressed when the performance plans for the eligible staff are presented to the Performance and Compensation Committee in December 2007.

In accordance with both the history of the CalPERS Investment Office, as well as with best practice in the investment industry, we will organize the new ILAC under the direction of a Senior Investment Officer (SIO) with ultimate responsibility for performance and the authority to create and maintain effective investment programs. The four component investment programs of the ILAC

(Commodities, Inflation-Linked Bonds, Infrastructure, and Forestland) will be overseen by the SIO of Asset Allocation given that the explicit functions of the Asset Allocation group are to add value through asset allocation activities and to add value in investment programs that do not fit neatly into the current four standard asset classes of Global Equities, Fixed Income, Real Estate, or Private Equity.

The opinion letter from Wilshire Associates on this item is attached.

Organization

The SIO-Asset Allocation will oversee the ILAC and its four components as set forth below. Unless otherwise noted, it is anticipated that the transfer of responsibilities to the SIO-Asset Allocation will occur January 1, 2008.

Commodities: The Commodities Pilot Program currently resides within Fixed Income. This program will be transferred and will be overseen by the SIO-Asset Allocation. Currently, one employee, a Portfolio Manager, handles this program. This position will be redirected from Fixed Income to Asset Allocation.

Inflation-Linked Bonds: These investments are currently integrated into the Fixed Income group and given the inherent complementarities between inflation-linked bonds with conventional nominal-rate bonds, trading and portfolio management personnel will remain in the Fixed Income group. In effect, the relationship will be a manager-client relationship, whereby the SIO-Asset Allocation will be the client with the ability to define benchmarks and initiate design/objective changes as needed. The SIO-Fixed Income (or direct reports) will manage the personnel and will act as a manager on behalf of the client, in much the same manner as our external portfolio managers act as managers on behalf of CalPERS as a client. The SIO-Asset Allocation will also manage the allocation of assets to the Inflation-Linked Bond component of the ILAC. (Note: The Fixed Income Unit will continue to have authority for the potential investment in inflation-linked bonds for tactical value-added purposes.)

Infrastructure and Forestland: Based on the best practice experience of major international pension plans, the ultimate target is to have dedicated staff to manage these programs. Staff currently intends to request two positions (one Senior Portfolio Manager and one Investment Officer III) as part of the 2007-08 mid-year request, and two additional positions (one Portfolio Manager and one Office Technician) as part of the 2008-09 request. Thus, once the four dedicated staff members are hired, they will report to and be managed by the SIO-Asset Allocation. However, because there are currently no dedicated personnel to Infrastructure or Forestland, the activity for both of these programs remains in the Real Estate and Private Equity groups. Until dedicated staff is hired and the programs are effectively transferred to the SIO-Asset Allocation, all Infrastructure

investments must be approved by a committee comprised of the SIOs of Asset Allocation, Real Estate, and Private Equity. Similarly, Forestland investments will be approved by a committee comprised of the SIOs of Asset Allocation and Real Estate.

Also during this interim period, Infrastructure investment staff will be hired by the SIO-Asset Allocation with the advice and support of the Real Estate and Private Equity groups, and Forestland investment staff will be hired by the SIO-Asset Allocation with the advice and support of the Real Estate group. Once the initial three investment professionals are hired, it is expected that staff will formally request to the CalPERS' Investment Committee that responsibility for the Infrastructure and Forestland Programs be officially transferred to the SIO-Asset Allocation and that the pilot program status of Infrastructure would end. The hiring of personnel and transfer of responsibilities is expected no later than June 2008.

Incentive Compensation

Changes in incentive compensation will be presented to the Performance and Compensation Committee in December 2007. The SIO-Asset Allocation will have responsibility for the overall ILAC as well as for the component performance of the Commodities, Infrastructure, and Forestland Programs beginning on January 1, 2008. Responsibility for the Commodities Program will transfer from the Fixed Income group on January 1, 2008. The SIO-Fixed Income and assigned personnel will have responsibility for the performance of the inflation-linked bond portfolio as will the SIO-Asset Allocation. The SIO-Real Estate will also have responsibility for Infrastructure and Forestland performance, and the SIO-Private Equity will have responsibility for Infrastructure from when they are carved out as distinctive programs (as of October 1, 2007) until they are formally transferred to the SIO-Asset Allocation, expected no later than June 30, 2008. Thus, from January 1, 2008 until the Infrastructure and Forestland are transferred, there will be shared responsibility for the performance impact of these programs with the SIOs of Asset Allocation and Real Estate. The incentive compensation arrangements will take into account all of the above performance responsibilities.

The performance benchmark for the ILAC and each component (Commodities, Inflation-Linked Bonds, Infrastructure and Forestland) will be stated in the ILAC Policy to be approved by the Investment Committee.

Delegations

Delegated responsibility for the component programs of the ILAC to the SIO-Asset Allocation will be submitted for approval in December 2007. The Commodities Program will be transferred from the SIO-Fixed-Income to the SIO-

Asset Allocation. Delegated authority for Infrastructure and Forestland investment decisions will be established for the committees comprised of the SIOs responsible for these programs until they are transferred to the SIO-Asset Allocation.

Consultants

In February 2007, staff presented an item to the Committee regarding the use of a consultant for the Commodities Pilot Program. Staff recommended that the Investment Committee rely upon Wilshire Associates, its General Pension Consultant, as the consultant for the Commodities Pilot Program. Staff indicated that if the Committee were to approve the ILAC (including commodities as well as the other components), staff would review the appropriate use of specialty consultants for the new asset class and report back to the Committee.

In the interim, the ILAC pilot has been approved. If the Investment Committee approves an allocation to and formalizes this asset class, staff will undertake the review of appropriate consultants and report back to the Committee. In the meantime, staff recommends that the Committee continue to rely upon its General Pension Consultant for the review and monitoring of the asset class. Staff recommends that the Committee also consult with Pension Consulting Alliance (PCA) regarding the infrastructure component.

The services that will be required of Wilshire and PCA fall within the scope of their existing General Pension Consultant and “back-up” General Pension Consultant contracts; as a result, no additional fees will apply. Additionally, staff may engage and direct specialized consultants in certain areas such as Infrastructure and Forestland.

V. STRATEGIC PLAN:

This item is intended to promote Goal IX to achieve long-term, sustainable, risk-adjusted returns by thinking creatively with respect to new investment opportunities and ensuring the sustainability of the portfolio returns.

VI. RESULTS/COSTS:

This item is not expected to have any material cost impact. The costs associated with the Inflation-linked Asset Class were outlined in the Inflation-linked Asset Class Pilot Program presented at the September 10, 2007 Investment Committee meeting (Item 4c).

Curtis Ishii
Senior Investment Officer
Fixed Income

Theodore Eliopoulos
Senior Investment Officer
Real Estate

Leon G. Shahinian
Senior Investment Officer

Farouki Majeed
Senior Investment Officer
Asset Allocation/Risk
Management

Anne Stausboll
Chief Operating Investment Officer

Russell Read
Chief Investment Officer